PensionCabal.com—Ruminations on the Cash Balance Crisis

We were planning to focus our editorial comments on ERISA's twenty-fifth birthday, but the ongoing brouhaha over cash balance plans demands our attention.

We are not sure who has had a rougher time recently—pension consultants who had the misfortune of being tape-recorded at Enrolled Actuaries meetings or the companies that have adopted cash balance plans. Talk about ironies. Employers have struggled for years to get employees to understand and value their defined benefit plans and thought they finally had found something worthwhile in the lump-sum-oriented cash balance plan. The avalanche of critical press accounts of cash balance plans coupled with the spawning of anti-cash balance web sites has produced a result that no one could have predicted. Cash balance plans have been demonized to the point of making yesterday's whipping boy—the old-fashioned social security integrated final pay plan—look good by comparison. We only wonder how long it will be before someone notices that the abbreviation for "cash balance" is "cabal." Now, be careful who you tell that to; it may be enough to drive your baby boom pension militia completely over the edge.

How did it even get to this point? How does a pension crisis bubble up over a type of plan that has been in the marketplace for over 15 years?

There seem to be lots of contributing factors. To begin with, the designers of these plans have gone overboard portraying them as "simple" from the beginning. Anyone who has had to draft one of these plans knows this is nonsense. Try as you might, there is no such thing as a simple defined benefit plan. From a purely technical standpoint, cash balance plans always have been about trying to put a square peg in a round hole. Consider the long-standing questions surrounding the application of the backloading rules to these plans. How can a plan be portrayed as simple if it took until 1996—some 11 years after the very public unveiling of the first cash balance plan—for the IRS first to articulate how ERISA's accrual rules apply to these plans.

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Despite the squareness of the cash balance attributes and the roundness of the ERISA rules, cash balance plans also have been deserving of more decisive analysis by government regulators. While we don't want to keep beating a dead horse to death (as Yogi Berra must have said), the IRS has been slow (in the geologic sense, as Ira Cohen used to say) to issue reliable guidance on cash balance plans. (For earlier horse-whippings, see "Whither Guidance?," Winter 1998, *Benefits Law Journal.*) The 1996 notice dealing with the backloading rules is nothing but a notice of intent to write a regulation someday. This is hardly a clear statement of the agency's position. Public announcements of the agency position in preambles to regulations and in Tax Court briefs are not the stuff to make a top-notch agency proud.

The failure to address the technical aspects of cash balance plans has left a number of legal loose ends that have served as a convenient target for cash balance critics. Take the *Onan* litigation in the Tax Court, for example. The news media has reported with great flourish the IRS arguments against plan qualification, implying that the IRS attack goes to the heart of these plans. These articles do not report that the *Onan* design is not seen in all plans, and particularly not the newer plan designs. More importantly, news accounts fail to mention that the issue in the *Onan* Tax Court case is whether that particular plan design violates the rules on backloading of accruals. The larger debate, however, is not about too much backloading of benefits in cash balance plans. Quite the opposite, the big picture is about doing away with backloaded plan designs in favor of front-loaded plan designs.

No, this debate is not about legal technicalities, but rather about something much more fundamental. What the cash balance critics find most objectionable is something that there is little legal basis to attack and that is the ability of plan sponsors to amend a plan at will to stop accruals altogether or, through the use of the much-maligned "wear away," to delay the timing of future accruals. Since ERISA clearly supports the plan sponsor's ability to amend its plan prospectively, the cash balance opponents have to resort to other arguments—in particular, the ADEA—to make their case. Attacking cash balance conversions under an age discrimination "disparate impact" argument may win political sympathy, but under the current state of the federal age discrimination law it does not present a strong case if advanced in the courts. Arguing that these plans fail to meet the "rate of accrual" requirement of Code Section 411(b)(1)(H) whether or not they involve "wear aways" of benefits may seem to present a more appealing target because of the vagueness of the statutory rule, but

age grading of cash balance interest credits is not likely to placate employees affected by cash balance conversions.

It is the public's sudden focus on the employer's amendment power that is the most surprising, and, from the plan sponsor's standpoint, the most alarming. It is surprising, given what has happened with retiree health plans over the last 15 years. Since the early 1980s, virtually every large company radically reduced or eliminated retiree medical benefits to combat medical cost inflation. These benefit reductions withstood challenge after legal challenge, with the courts upholding the employer's unrestrained power to amend an ERISA plan at will. Yet for some reason, these retiree medical plan changes did not produce the intense media and employee focus that cash balance plan conversions have. From a legal standpoint, there is no difference. So why the different politics?

Whose Money Is It?

One practical difference might be that the explanation was more clear-cut, and the threat more imminent in the retiree medical context. Many industries were suffering in the 1980s so that reduction of future medical benefits was easier to justify in the face of unparalleled medical cost inflation. Also, retirees have a basic medical plan to fall back on in the form of Medicare. In other ways, however, the retiree medical cases presented a more difficult set of questions, since the benefit cutbacks frequently involved already retired workers.

Maybe the explanation is more basic: follow the money. The attack on cash balance plans resonates because the economy is strong, the rate of inflation is low, and defined benefit plans are well funded as a result of unprecedented stock market gains. Middle-aged baby boomers look at these plans and see a part of "their" money being used to benefit individuals who are not only younger than themselves, but who have also yet to be hired by their employers.

From this perspective, the cash balance issue is not as much a matter of formulas and "wear aways" as it is debate of an old question—namely, whose money is it? As we found with the plan termination-restarts in the 1980s and the 1995 legislative debate over the use of plan surplus for non-pension benefits, the "whose money is it" debate is a highly charged emotional one. The surprising twist in this situation is that the case can be made at all. The plan sponsors are not using the "extra" pension money to benefit "the company" to build new plants and equipment, but rather to enhance benefits for young and new employees. Added to this highly emotional issue—

the "whose money is it" question—is the fact that, in contrast with the retiree medical situation, the core legal issue was settled *before* the debate. In *Jacobson v. Hughes Aircraft*, the Supreme Court held decisively that a pension plan's surplus assets do not "belong" to the plan participants. Rather, the surplus assets can be used to provide new benefits to new employees—employees whose wages in no way "contributed" to the buildup of the surplus. With the law settled by *Hughes*, participants enraged at the diversion of "their" pension money have no avenue but the political arena to claim it.

The employer response to all of the attacks on cash balance plans has done little to diminish the crisis atmosphere. For some reason, employers were slow to respond to media attacks. While a rope-a-dope defense sometimes proves effective, it does not work when the media attacks are led by business-friendly publications like *The Wall Street Journal*. The employer arguments also proved ineffective. Employers argue that to remain competitive they have to ration their limited benefit dollars and that the future health of these companies demands the moving of more benefit dollars to shorter-service employees. It is doubtless true that companies like IBM have to make themselves look more like Microsoft in order to compete, but arguments based on long-term strategies are difficult to sell, especially given the widespread perception that public companies are fixated on short-term results. Moreover, the case for rationing is more compelling when there are resource shortages. It is a difficult case to make when you have just harvested a bumper crop.

Curiously, employers have been unable to exploit for political gain the advantage that these plans offer for pension portability. For years, various public interest groups have championed the cause of quicker vesting and portability of pension benefits to deal with workers who come in and out of the workforce. For the advocate of portability, the most problematic plan design is the old-fashioned, integrated final average pay formula defined benefit plan. Critics have long charged that this formula disproportionately rewards the long-term, no-break employee, idealized in an economy long-gone. It ignores, for example, the needs of female workers whose work histories may be interrupted by the responsibilities of childrearing. It is this much criticized, old-fashioned formula that cash balance plans would replace. And the typical front-loaded cash balance plan has exactly the same results championed by longtime portability advocates: a faster benefit buildup for young employees, a fully portable "account," the elimination of the excess penalty for job change and job interruption. Cash balance plans are a perfect marriage of these

interests yet it seems that this message has been lost, and this alliance has not been forged.

Employers warn that they must be given the latitude to design plans freely if they are to remain competitive and that nothing should be changed to upset the precarious balance of the private pension system. This point cannot be ignored by policymakers. To our eye, defined benefit plans are in a death spiral and cash balance plans are but a last gasp of this system. The numbers cited at the September 1999 hearing before the Senate Health, Education, Labor and Pension Committee (the Senate HELP Committee) cannot be spun to tell a different story. The number of PBGC-reporting defined benefit plans has declined from 111,000 in 1987 to 43,000 in 1998. What more do the policymakers need to know? New companies simply are not adopting these plans. The reasons are many, including the high degree of regulation of these plans and their uncertain future cost. We also wonder whether these plans have been avoided for philosophical reasons—they simply do not fit in with the heightened entrepreneurial spirit that has been unleashed as a result of the successes in technology-based industries. It will not take much of a change in the form of new legal requirements or constraints on plan design to accelerate the defined benefit plan tailspin. Perhaps the only thing keeping many plans in place is the fact that many plans are in surplus and would face confiscatory income and excise taxes upon plan termination. The picture could change dramatically if the stock market were to fall.

By all appearances, the cash balance crisis of 1999 could prove to be a watershed event. Nowhere can this be seen more clearly than in its implications for future employee/management dealings. With the growth of the internet and intranet systems, employees are able to organize overnight on any issue. Lest there be any doubt about this, check out the IBM and other copycat Web pages for employees of cash balance companies. The IBM Web page had copies of legal briefs and other information before many experts knew of some of these materials. If IBM is concerned about the IBM employees' organizational efforts leading to the unionization of the employees, we think that union organizers should be more concerned. Why would anyone need a union if they are able to organize themselves on issues the way IBM employees have? Why spend the money on a standing army when the militia is just as effective?

How the cash balance crisis will be settled is anything but clear. At the Senate HELP Committee hearing in September the Treasury Department politely declined the Committee's invitation of help to

"clarify" the law. From our perspective, the Treasury's response makes sense if it was intended to head off a congressional quick-fix that might do more harm than good. It makes no sense, however, unless Treasury, IRS, and EEOC are willing to demonstrate a decisiveness on this subject that previously has been lacking. At the very least, the Treasury Department's strategy will require that the department address the age discrimination issues in an authoritative pronouncement before a district court judge gets there first.

We are concerned that the IBM cash balance plan conversion not be viewed as another Studebaker situation, giving rise to some son-of-ERISA response. Some Congressmen have cited with favor Canada's legal requirement that employees be offered a choice when a benefit formula is changed. But is there anything about the Canadian pension system that we really want to emulate? Adding employee-choice requirements will do for single employer defined benefit plans what the Multiemployer Employer Pension Protection Act did for multiemployer plans: it may keep the current 43,000 defined benefit plans in place, but you will not see any new plans adopted. If the cash balance debate proves anything, it proves that the proponents of defined benefit plans would be better served to come up with an attractive alternative plan that employers will want to adopt. Is it time to start talking about salary-reduction pension plans?

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